Table of Contents

	Page
Question Presented	1
Statutes and Regulations Involved	3
Statement	3
Argument	5
I. The Court of Claims erroneously held that a profit allowance from a negotiated settlement of a terminated Government contract was accruable as income in the year in which the negotiations reached a state of "sufficient agreement" for the amount of the profit allowance to be reasonably ascertained, instead of in the year when a binding settlement was reached	6
A. The Government's brief incorrectly analyzes the decision of the court below	6
B. The Court of Claims erroneously failed to apply the all-events rule and erroneously failed to hold that taxpayer's profit allowance did not accrue until the Settlement Review Board approved its settlement proposal in 1946	8
II. The decision of the Court of Claims is in conflict with the decisions of this Court on accrual tax accounting, decided in the October term, 1960	11
III. The conflict between the decision of the Court of Claims below and the decisions of this Court applying the all-events rule involves a principle of accrual of income from terminated Government contracts of importance to the revenue and of continuing application	16
Conclusion	18
Appendix	19

Table of Authorities Cited

Cases

Pages

American Automobile Association v. United States, 29 U.S. Law Week 4811 ..... 11, 15

Breeze Corporations v. United States, 114 F.Supp. 404 8

Commissioner v. Fifth Avenue Coach Lines, Inc., 281 F.2d 556, cert. den., 366 U.S. 964 ..... 12, 13

Com'r v. Milwaukee & Suburban Transport Corp., 29 U.S. Law Week 3378 ..... 11, 14, 15, 18

Consolidated Edison Co., U.S. v., 366 U.S. 380 ..... 11, 15

Continental Tie & L. Co. v. U.S., 286 U.S. 290 ..... 7, 8

Erie Basin M. Products, United States v., 244 F.2d 809 10

Fifth Avenue Coach Lines, Inc., Commissioner v., 281 F.2d 556, cert. den. 366 U.S. 964 ..... 12, 13

Globe Corporation, 20 T. C. 299, acq. 14

Liebes, H. & Co. v. Commissioner of Internal Revenue, 90 F. 2d 932 12

Masonite Corp. v. Fly, et al., 61-1 CCH USTC, par. 9355 .. 13

Milwaukee & Suburban Transport Corp., Comr. v., 29 U.S. Law Week 3378 ..... 11, 14, 15, 18

U.S. v. Consolidated Edison Co., 366 U.S. 380 ..... 11, 15

United States v. Erie Basin M. Products, 244 F.2d 809 10

Statutes and Regulations

Contract Settlement Act of 1944, c. 358, 58 Stat. 659 .....4, 6, 16

Treasury Regulations 111, sec. 29.42-1 ..... 8, 17

Joint Termination Regulation, 10 Fed. Register 10449, par. 583 ..... 10, 16

Income Tax Regulations, sec. 1.451-1, 26 C.F.R. 1.451-1 .... 3, 19

Miscellaneous

Mimeograph 5897, C.B. 1945, 131 8

Congressional Record (1944), Vol. 90, pp. 6061, 6130 10

In the Supreme Court
OF THE
United States

OCTOBER TERM, 1961

No. 118

FOOD MACHINERY AND CHEMICAL CORPORATION, a corporation,
Petitioner,
vs.
THE UNITED STATES,
Respondent.

PETITIONER'S REPLY BRIEF

This is a suit to recover an overpayment of income and excess profits taxes and interest thereon for the taxable year ended September 30, 1945. Taxpayer's petition for a writ of certiorari to the United States Court of Claims was filed on May 26, 1961. The Government's brief in opposition was filed on June 23, 1961.

QUESTION PRESENTED

The Government's statement of the question presented in its brief in opposition is accurate as far as it goes,

but it does not disclose the real issue in this case. The real issue here is, as indicated in the Government's brief (n. 4, p. 12), the proper legal standard for determining the year of accrual of a profit allowance resulting from the negotiated settlement of Government contracts terminated for the convenience of the Government. The standard applied by the majority of the court below in holding that such income accrued in the fiscal year 1945 was a subjective standard, based on an appraisal of the state of settlement negotiations between taxpayer and the Government. The majority held that the negotiations between the parties had reached a stage of sufficient agreement by the end of the fiscal year 1945 for the amount of taxpayer's profit allowance to be considered reasonably ascertainable at that time (Pet., p. 40).

Taxpayer contends that the majority of the court below erred in failing to apply the proper objective standard based on the all-events principle of accrual of income. Taxpayer contends, as Judge Whitaker held in his dissenting opinion that such profit allowance was not accruable as income until the year 1946, when a binding settlement was reached (Pet., p. 44).

The issue in this case, therefore, is whether the court below correctly held that all the events had occurred which were necessary to fix the amount of and taxpayer's right to receive its profit allowance when the state of negotiations at the end of fiscal year 1945 provided a reasonable expectation as to the amount taxpayer might receive, but no binding settlement had then been reached and was not reached until 1946.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set forth in taxpayer's petition for certiorari at page 3. Section 1.451-1 of the Income Tax Regulations on the taxable year of inclusion of items in income under the 1954 Revenue Code is set forth in the Appendix, infra, at pages 19-20.

STATEMENT

The facts will not be restated in detail, since they were set forth in taxpayer's petition for certiorari (pp. 3-9). However, certain inaccuracies and omissions appear in the Government's statement (Resp. Br., pp. 4-8). On page 5 of the Government's brief it is stated that taxpayer filed two joint inventory and settlement proposals, each covering four of the terminated contracts. While taxpayer received permission to do so, such settlement proposals were never filed. Difficulties which arose in the processing and apportioning of taxpayer's inventories on the basis of two joint claims prevented such filing (Finding 26, Pet., p. 57). Taxpayer, approximately two months after the close of the fiscal year 1945, filed one over-all claim embodied in its first settlement proposal, filed on November 27, 1945 (Finding 28, Pet., p. 57).

The statement in the Government's brief (p. 5) that the profit rate on which an understanding was reached on September 18, 1945, was subject to review by the Settlement Review Board in Washington, D.C., should be qualified to accord with finding 23 (Pet., p. 56) as follows:

"23. It was understood by and between the conferees for the parties at the pretermination conference, and by and between Mr. Davies and Captain Rosenstein at the meeting on September 18, 1945, that the 4.875 percent rate of profit would be subject to review by the defendant's Settlement Review Board in Washington. Negotiation was the only method of settlement used in settling plaintiff's termination claims, and all parties understood that written agreements would have to be reached."

The statement at the top of page 7 of the Government's brief that taxpayer made an explanation by letter in February, 1946, is incomplete. In addition to the explanation afforded by such letter of the variance between the estimated work in process and the amount reflected in taxpayer's claims, taxpayer agreed to waive certain substantial items of cost (Pet., p. 29; Findings 39 and 40, Pet., p. 62).

The Government is in error in stating in the first paragraph on page 8 of its brief that under the Contract Settlement Act of 1944 taxpayer had a right upon termination of its contracts to compensation for its material and labor expenditures and to a profit based on these costs. The Court held that under the Contract Settlement Act of 1944 the profit allowance for termination of taxpayer's contracts was left for negotiation by the parties and was to be a figure which would provide "fair compensation" to the contractor (Pet., p. 36). The Court held that the rate of profit was sufficiently established when the substance of the settlement proposal had been worked out between the contractor and the Government's contracting

officer, even though such agreement was tentative and not binding on either party, as was the case in the pretermination agreement negotiations (Pet., pp. 37-38; Finding 15, Pet., pp. 52-53; Finding 23, Pet., p. 56).

ARGUMENT

The Government opposes taxpayer's petition on the grounds that, in holding that taxpayer's profit allowance was properly accruable as income in the fiscal year 1945, the Court of Claims followed accepted rules of accrual basis tax accounting, and that there is no conflict and no occasion for further review. Taxpayer contends that the Court of Claims applied an improper rule for the accrual of taxpayer's profit allowance, and one which is in conflict with the accrual rules recently laid down by this Court during the October, 1950, term. Taxpayer further contends that this conflict should be resolved and the correct rule applied because of the important continuing question involved relating to the tax treatment of income from terminated Government contracts.

I

THE COURT OF CLAIMS ERRONEOUSLY HELD THAT A PROFIT ALLOWANCE FROM A NEGOTIATED SETTLEMENT OF A TERMINATED GOVERNMENT CONTRACT WAS ACCRUABLE AS INCOME IN THE YEAR IN WHICH THE NEGOTIATIONS REACHED A STATE OF "SUFFICIENT AGREEMENT" FOR THE AMOUNT OF THE PROFIT ALLOWANCE TO BE REASONABLY ASCERTAINED, INSTEAD OF IN THE YEAR WHEN A BINDING SETTLEMENT WAS REACHED

A. The Government's brief incorrectly analyzes the decision of the court below.

In discussing the decision of the court below the Government makes several erroneous statements. It is stated that taxpayer had a right to compensation for costs incurred under the terminated portions of the contracts for materials and labor, as well as an allowance for profit on these costs (Resp. Br., p. 9). As the court below correctly held, taxpayer's right to compensation under the Contract Settlement Act for termination of its contracts was a right to "fair compensation." The amount of fair compensation was left to negotiation between taxpayer and the Government, and the negotiations proceeded on the basis of according taxpayer various costs, including costs of raw materials and inventories, plus a negotiated rate of profit based on those costs.

The Government is grossly in error in its assertion that taxpayer conceded below that it had a "fixed right" to a profit allowance when the contracts were terminated, and that it is now seeking to raise a new issue in this Court by arguing that its right to receive its profit allowance did not become fixed until a binding settlement was reached in 1946 (Resp. Br., n. 2, p. 9, and p. 13). Taxpayer conceded only that on termination of its contracts

it had the right to receive "something" (Pet., p. 33). This was nothing more than a recognition that its unliquidated claim or cause of action against the Government for fair compensation arose at the time its contracts were terminated. It did not concede, as must be apparent from the opinion of the court below, that its right to a profit allowance was "fixed"[1] in a tax accrual sense at the time of termination of its contracts.[2]

The Government erroneously states that the court below applied the principles of *Continental Tie & L. Co. v. U.S.*, 286 U.S. 290, to the instant case, and that it made only a factual distinction between the instant case and the *Continental Tie* case (Resp. Br., pp. 9, 12). The court below clearly distinguished the *Continental Tie* case from this case on the basis of a legal, not a factual, difference between the cases. It held that the award in the *Continental Tie* case required only a *computation* which could be made from the books and accounts of the taxpayer, whereas the right to fair compensation in the instant case required *negotiation*, and could not be resolved solely by recourse to

[1]The Government's play on the term "fixed" is in keeping with its play on the term "objective" on page 13 of its brief, both of which references are calculated to cloud the issue presented.

[2]This is clearly apparent from the points stated in taxpayer's brief and reply brief filed in the Court of Claims. Heading II of taxpayer's brief reads as follows:

> "Plaintiff did not have a fixed, determined and enforceable right to receive a reasonably ascertainable amount of profit allowance on its terminated war contracts until 1946, the year of settlement of its termination claims."

Heading II of taxpayer's reply brief reads as follows:

> "Defendant's brief does not dispute plaintiff's contention that the Contract Settlement Act of 1944 by its terms did not prescribe a fixed, determined and enforceable right to a reasonably ascertainable amount of profit allowance."

the books and accounts of the taxpayer. The court below, therefore, as it had done previously in *Breeze Corporations v. United States*, 114 F. Supp. 464 rejected the position taken by the Government in Mimeograph 5897 (C.B. 1945, 131) and in its Regulations, in reliance on the *Continental Tie* case, that the profit allowance accrued at the time of termination.

While the Government cites Mimeograph 5897 and section 29.42-1 of Treasury Regulations 111 in its brief (Resp. Br., n. 3, p. 11), it does not now assert in its brief that taxpayer's profit allowance accrued at the time of termination of taxpayer's contracts, a position which it urged below and which was rejected by the court below. Instead it now seeks to uphold the decision of the court that the income was accruable when the rate of profit was reasonably ascertainable in the light of the negotiations between taxpayer and the Contracting Officer, even though by the close of the fiscal year 1945 the negotiations had not culminated in any binding settlement agreement. It is submitted that this decision is contrary to the tax accrual principles laid down by this Court and so recently affirmed during the October, 1960, term that income is not accruable until all of the events have occurred which fix the amount of the income and the fact of taxpayer's right to receive it.

B. The Court of Claims erroneously failed to apply the all-events rule and erroneously failed to hold that taxpayer's profit allowance did not accrue until the Settlement Review Board approved its settlement proposal in 1946.

The event relied upon by the court below as establishing the accrual of taxpayer's profit allowance was an

understanding reached between taxpayer and the Contracting Officer as to the rate of profit taxpayer would claim and which the Contracting Officer would recommend for allowance. This was reflected in a letter dated September 21, 1945. It is clear that the Contracting Officer had no authority to enter into a binding settlement of taxpayer's claim for a profit allowance on its terminated contracts. All he was authorized to do was to negotiate with the taxpayer and make recommendations on the taxpayer's proposed settlement. The law and the regulations expressly provide that no negotiated settlement in an amount in excess of $50,000 was binding on the Government until the proposed settlement had been reviewed and approved by the Settlement Review Board (Pet., pp. 74-75, 84-86; see also Findings 23, 42, Pet., pp. 56, 63). At the close of the fiscal year 1945 the taxpayer had not even filed its claim for compensation and did not file its first settlement proposal until November 27, 1945. It is thus clear that the Court of Claims based its accrual of the profit allowance on an appraisal of the state of negotiations between taxpayer and the Government on the settlement of its claim, for not only had the taxpayer's claim not been allowed prior to the end of fiscal year 1945, but it had not even been submitted.

The court below made no mention in its opinion of the all-events rule for accrual. Yet this Court has repeatedly held, and so recently affirmed in the cases decided at the October term, 1960,[3] that accrual of income must await all the events that fix the fact and amount of the right to

[3]These cases are discussed infra at pp. 11-15.

receive it. That all such events had not occurred prior to fiscal 1945 is clearly apparent. Not until the Settlement Review Board approved taxpayer's settlement proposal was there any binding liability on the part of the Government to pay a profit allowance (*United States v. Erie Basin M. Products*, 244 F.2d 809).

The court below was in error in stating that the agreement between the contractor and the Government Contracting Officer established the taxpayer's right to a reasonably ascertainable amount (Pet., pp. 37 and 38). There was no agreement in a contract sense between taxpayer and the Contracting Officer (Finding 23, Pet. p. 56). All that occurred prior to the close of fiscal year 1945 was an understanding that taxpayer would propose a settlement and the Contracting Officer would recommend its acceptance by the Settlement Review Board. The discretion as to whether the settlement proposed by taxpayer would be accepted and made binding on the Government rested with the Settlement Review Board.[4] In this case at the hearing on taxpayer's claim the Board considered the evidence, discussed the various items of the claim, and gave its approval on March 27, 1946 (Finding 42, Pet., p. 63).[5] As dissenting Judge Whitaker held, this was the event that

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[4]In the House debate on the Contract Settlement Act of 1944, Mr. Vinson disclosed that the express purpose of providing for review by the Settlement Review Board was to vest the Board with the discretion of binding the Government on settlements involving large sums of money (90 Cong. Rec. 1944, 6061, 6130).

[5]Under the regulations describing the scope of review of the Settlement Review Board, it was authorized to inquire into specific selected items of the proposed settlement and could act upon records submitted by the Contracting Officer or require the submission of additional information (J.T.R. 583, Pet., pp. 85-86).

fixed the fact and the amount of taxpayer's right to receive its profit allowance (Pet., p. 44).

II

THE DECISION OF THE COURT OF CLAIMS IS IN CONFLICT WITH THE DECISIONS OF THIS COURT ON ACCRUAL TAX ACCOUNTING, DECIDED IN THE OCTOBER TERM, 1960

When the petition was filed in this case this Court had not yet decided the cases of *American Automobile Association v. United States*, 29 U.S. Law Week 4811, *U.S. v. Consolidated Edison Co.*, 366 U.S. 380, and *Comr. v. Milwaukee & Suburban Transport Corp.*, 29 U.S. Law Week 3378. They are therefore not discussed in taxpayer's petition. The Government's brief was filed on June 23, 1961, after these cases were decided, but made no mention of them. The position of the Government as to the application of the tax accrual principles laid down in those cases to the instant case is therefore not disclosed. However, it is manifest that the decision of the court below is in direct conflict with the accrual tax accounting principles set forth in those cases. The Court of Claims in the instant case accrued the profit allowance when it considered that the amount thereof was reasonably ascertainable. However, under the all-events rule as laid down by this Court in the above cases, an item of income or expense does not accrue when a reasonable estimate of the amount can be made; rather this court has held that an item of income or expense does not accrue until all of the events have occurred which fix the amount, as well as the fact of

liability to pay it in the case of an expense, or the right to receive it in the case of income.

The instant case parallels two cases considered by this Court in the October, 1960, term, one case in which certiorari was denied, the other case in which the Government's petition for certiorari was granted and the decision below vacated per curiam. In the first case, *Commissioner of Internal Revenue v. Fifth Avenue Coach Lines, Inc.*, 281 F.2d 556, certiorari denied 366 U.S. 964, the question involved was the year of accrual of a deduction for interest on a judgment against the taxpayer. The taxpayer claimed a deduction in the year in which a decision had been made on the part of its officers not to prosecute an appeal from the judgment rendered against it. The time for taking the appeal, however, did not expire until the next year. The Second Circuit Court of Appeals held that the all-events rule required that the deduction for interest await the expiration of the time for appeal, because not until then had all the events occurred to fix the liability. At page 559 it cited with approval the decision of the Ninth Circuit in *H. Liebes & Co. v. Commissioner of Internal Revenue*, 90 F.2d 932, where the court stated as follows:

> "If appeal is taken, the right is not fixed until determination of the appeal; and if no appeal is taken, * * * the right becomes fixed on termination of the appeal time."

In the *Fifth Avenue* case the Second Circuit Court pointed out that, while such a standard might be termed mechanical, it offered a clear guide to taxpayers, promoted ease of administration and contributed to certainty of revenue.

It found neither theoretical nor practical justification for introducing the complexities involved in determining reasonableness of expectation of appeal. The court also pointed out the opportunity for manipulation if a subjective standard based on intent was applied. The decision of the court below in this case is based on the subjective standard of intent rejected by the Second Circuit in the *Fifth Avenue* case, because it is based on an appraisal of the state of negotiations between the parties.[6] Awaiting the binding administrative action on its settlement proposal, as taxpayer contends, follows precisely the rule for accrual laid down by the Second Circuit in the *Fifth Avenue* case. Such a rule is objective, is not based on factors of intent, contributes to certainty, and promotes ease of administration. Having the accrual of the profit allowance await the binding action by the Settlement Review Board rests the accrual on the identifiable event which fixed the taxpayer's right to receive and the Government's liability to pay it.

The recent case of *Masonite Corp. v. Fly et al.*, 61-1 CCH USTC, par. 9355, illustrates this rule. There the question was the accrual as income of a refund of Mississippi income taxes. The taxpayer's right to a refund required the approval of the Attorney General of the state. The court held that the income did not accrue until the refund was approved.

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[6]The Government's play on the word "objective" in its brief (p. 13) is no answer to taxpayer's contention that the Court of Claims rule for accrual is based on subjective factors, namely, the intent on the part of taxpayer to offer to settle its claims, and intent on the part of the Contracting Officer to recommend such settlement.

The decision of the court below is also contrary to the decision of the Tax Court in *Globe Corporation*, 20 T.C. 299, acq. While the court below distinguished the instant case from the *Globe* case on the ground that in the *Globe* case the negotiations had not reached any agreement, however tentative, on the amount or the method of computing fair compensation, it is clear that the Tax Court in the *Globe* case applied the all-events rule. It held that accrual was not required until all the events had occurred which fixed the amount and the right to receive the fair compensation, namely the entering into of a binding agreement as the result of the negotiations.

This case also resembles the *Milwaukee & Suburban Transport* case, supra. In that case the taxpayer, a common carrier filing its returns on the accrual basis, set up on its books a reserve account to reflect estimated amounts of contingent liabilities for contested and unsettled personal injury and property damage claims arising out of the operation of its transportation facilities, and deducted such amounts on its tax return. The Tax Court held that these estimated amounts were not accruable in the years in which they were claimed, since taxpayer's liability had not become definite but, on the contrary, was being contested. The Court of Appeals for the Seventh Circuit reversed, holding that, although taxpayer's liability for each individual claim was being contested and remained contingent, the aggregate amount of over-all liability could be accurately predicted. The Government petitioned for certiorari to this Court, stating:

> "In so holding the court below violated the settled annual accounting rule, and the equally settled corol-

lary principle that an item of deduction (expense, loss, etc.) is accruable as an offset against gross income only in the taxable year in which the liability to pay it becomes fixed, in *fact* as well as in *amount*" (No. 843, October Term, 1960, Pet., p. 7).

This Court, per curiam, supra, granted the Government's petition for certiorari and vacated the judgment below in the light of the *American Automobile Association* and *Consolidated Edison* cases. The same action is required here. The court below based its accrual, as did the Court of Appeals for the Seventh Circuit in the *Milwaukee & Suburban Transport* case, on a reasonably accurate prediction or estimate of the amount at the end of the taxable year. As the Government contended in the *Milwaukee & Suburban Transport* case, which contention was sustained by this Court in reversing the Seventh Circuit, the accrual of an item requires that it become fixed in fact as well as in amount. The amount of the profit allowance of taxpayer was not fixed when the Contracting Officer and taxpayer reached a tentative understanding as to the rate of profit that the taxpayer would claim in its settlement proposal and which the officer would recommend for allowance by the Settlement Review Board. It was not fixed until a binding settlement was reached by the action of the Settlement Review Board. Not until then had all of the events occurred necessary to fix the fact and the amount of taxpayer's right to receive its profit allowance, and not until then can the profit allowance be accrued as income. This Court should therefore take the same action that it took in the *Milwaukee & Suburban Transport* case, namely, grant certiorari in this case and vacate the judgment below.

III

THE CONFLICT BETWEEN THE DECISION OF THE COURT OF CLAIMS BELOW AND THE DECISIONS OF THIS COURT APPLYING THE ALL-EVENTS RULE INVOLVES A PRINCIPLE OF ACCRUAL OF INCOME FROM TERMINATED GOVERNMENT CONTRACTS OF IMPORTANCE TO THE REVENUE AND OF CONTINUING APPLICATION

One of the reasons urged by taxpayer for the review of this case was the substantial amount of revenue affected by the question of the accrual of income from terminated Government contracts involved in this case. The Government does not refute taxpayer's assertion that the rules governing the allowance of compensation for terminated Armed Services contracts today are precisely the same as those governing the allowance of compensation under the Contract Settlement Act of 1944. It does not refute taxpayer's statement as to the large number of terminated Armed Services' contracts and enormous amounts currently involved in the settlement of such claims. It contents itself with stating that the issue is of little, if any, importance for the future, since it relates to the accruability of compensation under terminated World War II contracts (Resp.Br., p. 13). However, the Joint Termination Regulation which governed the settlement of terminated war contracts under the Contract Settlement Act of 1944 is precisely the same as the Armed Services Procurement Regulations currently in force which govern the settlement of terminated Armed Services contracts. The question of the proper year for the accrual of profit allowances under contracts now being terminated under the Armed Services Procurement Regulations must therefore be precisely the same as the question

here presented of the proper year for accrual of profit allowances on war contracts terminated under the Contract Settlement Act. It is no answer to say that the Government now knows of no other pending cases. The issue is the same and cases will surely arise if this Court permits this erroneous decision of the Court of Claims to remain unreversed, and the Government seeks to apply it. If, instead, the Government will follow the correct rule as contended for by the taxpayer, then it will be manifestly unjust to leave standing the decision of the court below to the contrary.

The Government in this case, while seeking to uphold the decision of the court below, nowhere states in its brief what it contends is the correct rule for accrual of income from terminated Government contracts. It is significant that the regulation under the 1954 Code setting forth the general rule for the taxable year of inclusion of income omits the rules relating to income from terminated Government contracts which appeared in Treasury Regulations 111 under the 1939 Code applicable to this case. These omissions are shown in the appendix. The regulations presently in force do not contain any express statement that claims for compensation from cancelled or terminated Government contracts must be included as income in the year in which they are allowed. If this change in the regulations and the Government's position before the Court in this case that the decision below is correct means that the Government's position now is that claims for compensation under cancelled or terminated Government contracts are accruable as income, not in the year in which they are allowed, but rather in the year

in which the state of negotiations permit a reasonable ascertainment of the amount of compensation to be allowed, then indeed is this case of far reaching importance. This Court should clear up the confusion and uncertainty that would arise from an acceptance of the decision of the Court of Claims.

Even if this Court does not, as taxpayer respectfully submits should be done, grant certiorari and reverse the decision below on the authority of the *Milwaukee & Suburban Transport* case, supra, it should at least grant certiorari to resolve as a rule of law on the accrual of income from terminated Government contracts which is of continuing importance, not only to the revenues, but to a large number of taxpayers as well.

CONCLUSION

For the reasons stated above the petition for a writ of certiorari should be granted and the judgment of the court below vacated.

Dated: August 28, 1961.

Respectfully submitted,

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(Appendix Follows)